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April 10, 2006

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RECEIVED
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OFFICE OF THE SECRETARY

Re: Comments on Proposed Amendments to Mutual Fund Redemption Fee Rule (File No. S7-06-06)

Dear Ms. Morris:

This letter is submitted on behalf of the Committee of Annuity Insurers (the "Committee").[1] The Committee is pleased to have the opportunity to offer its comments in response to the request of the Securities and Exchange Commission (the "Commission") in Release No. IC-27255 (February 28, 2006) (the "Rule 22c-2 Amendment Proposing Release") for comments on proposed amendments to recently adopted Rule 22c-2 (the "Rule") under the Investment Company Act of 1940 (the "Investment Company Act").[2]

The Rule was adopted in response to market timing developments in the investment company industry. The Rule has two primary provisions. First, to curb abusive and excessive trading in fund shares, the Rule permits open-end management investment companies (commonly known as "mutual funds"), including series thereof (referred to as "funds"), to impose redemption fees to discourage "market timing" and/or to recoup expenses incurred as a result of frequent trading activity. Second, the Rule addresses an issue that funds have been required to address in attempting to curb abusive and excessive trading — because many funds' shares are held in omnibus accounts at financial intermediaries, such funds generally do not have information regarding individual transactions by shareholders that is necessary to identify and place restrictions on abusive or frequent trading. The Rule addresses this issue by imposing data reporting and transaction restricting and blocking requirements that provide funds with "transparency" to look through financial intermediaries and restrict or block individual shareholder transactions where appropriate.

When it adopted the Rule in 2005, the Commission requested comment on a number of topics it wanted to continue to study, including whether to mandate standardization for

[1] The Committee of Annuity Insurers is a coalition of 29 life insurance companies that issue fixed and variable annuities. The Committee was formed in 1981 to participate in the development of federal securities law regulation and federal tax policy affecting annuities. The member companies of the Committee represent over half of the annuity business in the United States.

[2] The Rule was adopted by the Commission on March 11, 2005. *See* Mutual Fund Redemption Fees, Investment Company Act Release No. 26782 (Mar. 11, 2005) [70 FR 13328 (Mar. 18, 2005)] ("Rule 22c-2 Adopting Release"). Compliance with the Rule is not yet mandatory, however, because the compliance date for the Rule is October 16, 2006. As discussed herein, the Commission has proposed amendments to the Rule before its compliance date because of comments it received after the Rule was adopted.

redemption fees and whether there should be special provisions for variable annuities and variable life insurance products ("variable contracts"). In response to the comments it received, the Commission, on February 28, 2006, proposed amendments to the rule that were intended to: (i) clarify certain interpretations of the rule; (ii) enable funds and intermediaries to reduce the costs associated with entering into information sharing agreements mandated under the Rule; and (iii) enable funds to focus their efforts to deter short-term trading on the entities most likely to violate fund policies against such trading. Unfortunately, however, the Commission did not address most of the unique problems that the Rule will create for issuers of variable annuity (and life insurance) contracts.

The Committee supports the Commission's efforts to protect long-term investors in mutual funds and variable annuities from abuses stemming from short-term or frequent trading activities. The Committee particularly appreciates the Commission's recognition that amendments to the Rule may be needed "to address the special circumstances of insurance company separate accounts." These comments are intended to so assist the Commission in revising the Rule, and in fact, the Committee believes very strongly that without a significant extension of the compliance date, and certain fundamental revisions to the Rule, the variable contract industry will not be able to comply with the Rule.

We urge the Commission to carefully consider the comments made in this letter. We also urge the Commission to re-evaluate the comments the Committee made in its last comment letter on the Rule. The Committee does not believe that the Commission took the structure of variable contracts into account when it adopted the Rule and did not provide adequate guidance for the industry to apply the rule. We are therefore re-submitting our prior comment letter of May 9, 2005, as an exhibit to this comment letter.[3]

I. Structure of Variable Annuities

A variable annuity is a written contract between the insurance company that issues the variable annuity and the owner who purchases the contract.[4] The contract sets forth the rights and duties of the respective parties. Under state contract law, one party to a contract generally cannot unilaterally modify the contract terms.

Today, most variable annuities are issued through a two-tiered structure. The top tier consists of a separate account of the issuing insurance company, which is a segregated investment account established under state insurance law that holds variable annuity assets and

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[3] Letter from Sutherland Asbill & Brennan LLP (on behalf of the Committee of Annuity Insurers) to Jonathan G. Katz, Secretary, Securities and Exchange Commission (May 9, 2005) (additional comments on Rule 22c-2 as adopted, File No. S7-11-04).

[4] For ease of reference, this comment letter refers to insurance companies as issuers of variable annuity contracts although, under the federal securities laws, insurance company separate accounts are the primary issuers of variable annuity contracts, with the insurer as a separate entity co-issuing the contract. *See* Stephen E. Roth, Susan S. Krawczyk, and David S. Goldstein, *Reorganizing Insurance Company Separate Accounts Under Federal Securities Laws*, 46 Business Lawyer 546 (Feb. 1991).

liabilities separate and apart from the assets and liabilities of the insurance company's general account. Absent an exemption from the registration requirements of the Securities Act of 1933, variable annuity contracts are registered as securities under that Act. Similarly, absent an exemption from the Investment Company Act, the separate account must be registered under the Investment Company Act. Such separate accounts generally are registered as unit investment trusts ("UITs") and are divided into subaccounts. The fact that such separate accounts are registered as investment companies is, of course, a fundamental distinction between the separate accounts and other types of financial intermediaries subject to Rule 22c-2, such as broker-dealers and other entities that hold securities in nominee name.

The bottom tier of the two-tiered structure typically consists of a number of registered mutual funds. Each subaccount corresponds to, and is invested exclusively in, a particular series, or portfolio, of one of the funds. Today's variable annuities generally offer dozens of subaccount or portfolio choices, and give the contract owner the opportunity to select from portfolios offered by a dozen or more different mutual fund complexes.[5]

For tax reasons,[6] the funds that are available through registered insurance company separate accounts cannot be available directly to the public. Accordingly, mutual fund complexes have created separate funds, apart from their "retail" funds, that are available only to insurance company separate accounts (and certain qualified retirement plans). These specially dedicated funds are referred to as "insurance product funds." [7]

Under this structure, variable annuity owners allocate premium payments among the subaccounts offered within the contract, and may transfer contract value among those subaccounts in accordance with the terms of the contract. Each subaccount, in turn, invests in a corresponding portfolio. However, the insurance company is the actual owner of fund shares, and the insurance company does not hold them in trust for the contract owners.[8]

Operationally, variable annuity owners do not actually engage in transactions in shares of the fund portfolios. Rather, contract owner transactions (and other elements of variable insurance products, such as periodic deductions of charges, payment of death benefits, *etc.*) take place in the form of purchases in, or redemptions from, the subaccounts. To account for amounts allocated to, or withdrawn from, a subaccount as a result of purchase payments, withdrawals and transfers, and other transactions, values in each subaccount generally are measured in terms of "accumulation units." Each subaccount has its own accumulation unit value that is distinct from the net asset value per share of its corresponding fund portfolio. On a daily basis, the insurance company aggregates all orders received from contract owners with respect to a particular

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[5] One or more of those mutual fund complexes may be managed by an affiliate of the insurance company, but most products offer a large number of portfolios that are part of unaffiliated mutual fund complexes.

[6] *See* Section 817(h) of the Internal Revenue Code.

[7] In some cases, shares of "retail" mutual funds, that are available to the general public, are also sold to insurance company separate accounts. The comments and recommendations made herein also apply in that context.

[8] *See* Rule 26a-2(a) under the Investment Company Act.

subaccount, and transmits net purchase or redemption orders ("omnibus orders") to the fund in which the subaccount is invested.

II. The Committee's Recommendations

The proposed amendments to Rule 22c-2 would not involve changes to the fundamental elements of the rule (allowing funds to impose a redemption fee and requiring funds to enter into information sharing agreements) but rather are designed to clarify the operation of the rule and to reduce the number of intermediaries with which funds must negotiate information-sharing agreements. While laudable, the proposed amendments do not accommodate (or even recognize) the special circumstances facing registered insurance company separate accounts.[9]

The Commission should be as motivated to act in the best interests of investors in variable annuities (which are, after all, interests in registered investment companies) as it is in acting in the best interests of direct investors in retail funds. Yet, given the inherent differences between retail funds and variable annuities (especially, the two-tiered structure of most variable annuities) the Rule simply cannot apply to investors in variable annuity contracts in the same manner as it applies to investors in retail funds. As the Committee previously has noted in comments on the Rule as adopted, applying the Rule in the same manner to both "retail" funds and variable insurance products is not necessary to achieve the purposes of the Rule, and doing so would cause significant problems for issuers of variable annuities and would be contrary to the best interests of investors in variable annuities.

Accordingly, the Committee respectfully raises the following concerns and makes the following suggestions and recommendations concerning the proposed amendments to the Rule as they would apply in the context of variable insurance products:

- Insurers attempting to implement the Rule in the context of variable annuities face enormous administrative challenges, not the least of which involve the modification or replacement of existing administrative systems and procedures to administer redemption fees and engage in information sharing and transaction blocking with multiple fund complexes. To comply with the Rule, the Committee strongly urges the Commission to extend the compliance date of the Rule (October 16, 2006) an additional 18 months from the later of October 16, 2006 and the date the Commission adopts amendments to the Rule.

[9] As discussed below in Section II.E, there are significant assets invested in unregistered group variable annuity contracts that are issued through unregistered separate accounts. For the reasons discussed in that section, unregistered separate accounts issuing group contracts may in practice be confronted with many of the same redemption fee, shareholder information agreement and transaction blocking issues as registered separate accounts. References in this letter to variable annuities or separate accounts, other than in the discussion contained in Section II.E regarding unregistered separate accounts or as noted, are to registered variable annuity contracts or registered separate accounts, as the case may be.

- The Committee urges the Commission to clarify that the Rule does not require, and the Commission does not expect, issuers of variable annuities to administer the many and different market timing policies and procedures of underlying funds, and that underlying funds can instead, where appropriate, rely on the market timing policies and procedures of separate accounts (also registered investment companies). The Committee urges the Commission to recognize and take into account the very significant legal and practical challenges for insurers attempting to implement the various market timing policies of multiple funds from different fund complexes in a single variable annuity.

- The Committee urges the Commission to make the determination that a request to transfer within a variable annuity to a fund that has blocked further transfers or purchases by the contract owner is a transfer request that is "not in good order" and cannot be processed.

- The Commission should provide reasonable limits on the types and amounts of shareholder transaction data that insurance companies must provide and on the frequency in which such data must be provided.

- The Committee also urges the Commission to re-consider and respond to the comments made in prior comment letters as they relate to variable insurance products.

Each of these recommendations is discussed more fully below.

A. <u>Extension of Compliance Date</u>

Compliance with the Rule poses numerous and substantial administrative complexities and legal issues for insurance company separate accounts that qualify as financial intermediaries under the Rule. For many reasons, including their structure, UIT separate accounts funding variable annuities face challenges that do not arise for retail funds and their other financial intermediaries. Specifically, as noted above variable annuities typically have dozens of different, often unaffiliated, funds from different fund complexes as investment options. Even with the proposed amendments, insurance company depositors of such UIT separate accounts must enter into agreements with each such fund that imposes a redemption fee. Allowing different redemption fees that each may operate differently — *i.e.,* that may vary in amount, holding period, accounting methods and applicability — within a single variable annuity contract poses a daunting and manifestly costly challenge for insurers attempting to administer the numerous redemption fees, and is likely to result in lengthy and complicated disclosure that will bewilder purchasers of variable annuities.

Moreover, issues relating to the lack of uniformity with respect to redemption fees and the absence of standards for the shareholder information agreements mandated by the Rule will hamper an insurance company's ability to develop systems and procedures to comply with the Rule. The reprogramming and system modifications that will be required to provide data downloads requested by funds, and to block individual contract owner trades at the request of funds, will require fundamental and extensive revisions to existing administrative systems and procedures that will be substantial, time-consuming and costly, and/or may require the development or purchase of new systems altogether.

Accordingly, to provide adequate time for insurance companies to coordinate the administration of redemption fees for multiple fund complexes (and the remittance of those fees to the funds), and to accommodate the exchange of shareholder information and the trading restrictions that various fund complexes may request under written agreements mandated by the Rule, the Committee respectfully requests that the Commission extend the compliance date to 18 months from the latter of October 16, 2006 or the date of adoption of amendments to the Rule.

B. <u>Market Timing Policies of Insurance Product Funds</u>

The proposed amendments to the Rule do not address the practical difficulties an insurance company issuer of a variable annuity faces in enforcing not only its own policies to detect and deter frequent transfers, but also the policies to thwart market timing adopted by each fund with portfolios that are investment options under the variable annuity.

First, with respect to the Commission's determination to categorize insurance companies issuing variable contracts as "intermediaries" that must implement each different underlying fund's frequent trading policies, we believe the Commission has not given adequate consideration to the fact that variable annuity issuers, unlike other intermediaries, have effectively been required under new Commission rules to establish their *own* frequent trading policies and procedures. As noted, variable annuity contracts are issued through insurance company separate accounts that, absent an applicable exemption, are registered investment companies. As was the case for mutual funds, new disclosure rules adopted by the Commission have effectively required insurance companies to develop policies and procedures to protect contract owners from market timing and other programmed, large, frequent, or short-term transfers among subaccounts that may have adverse effects for other contract owners.

Under Rule 22c-2, insurance company issuers of variable contracts must enter into shareholder information agreements that require the insurance company to provide transaction information about contract owners, and, upon the request of the fund, to execute fund instructions to impose trading restrictions against investors the fund has identified as violating its market timing policies. The Rule, through the required written agreements between funds and financial intermediaries, could be read to imply that insurers and other intermediaries must (i) administer all of the different fund complexes' redemption fee (if any) on contract owner (or participant) transactions, (ii) remit the proceeds to the fund, and (iii) enforce the various fund's market timing policies with respect to annuity contract owners and plan participants. This would be an impossible task for some companies, or at least so difficult and expensive that some insurance companies are already considering removing some funds as investment choices in their variable annuity offerings.

Expecting insurance companies with separate accounts registered as investment companies to administer and enforce market timing policies and procedures of underlying funds would as a practical matter create on overlay of different sets of market timing policies and procedures (those of the separate account, and those of the underlying portfolios). Accordingly, the Committee respectfully submits that, contrary to the statement in the Initial Regulatory Flexibility Analysis in the Rule 22c-2 Amendments Proposing Release,[10] if insurance companies are expected to implement and enforce the underlying funds' various market timing policies and procedures, this operation of Rule 22c-2 *would duplicate, overlap or conflict with* the requirement that UIT separate accounts and their insurance company depositors disclose their market timing policies and procedures (or disclose why it is appropriate not to have such policies and procedures in place).[11]

Moreover, as noted above, it is common for dozens of portfolio choices from a dozen or more mutual fund complexes to be available as investment options under a single variable annuity contract. The funds available to a single variable annuity separate account are likely to have multiple, different, and inconsistent market timing policies and procedures. As a practical matter, then, it would be difficult, if not (virtually) impossible for an insurer to enforce the market timing policies of the each of the multiple fund complexes with portfolios that are investment options under each of its variable annuity contracts. As a result, insurance companies realistically may be required to discontinue as investment options funds that cannot rely primarily on the insurer's own frequent trading policies and procedures to curb frequent trading.

For these reasons, the Committee respectfully requests and recommends that the Commission explicitly state that the Rule does not require insurance companies to administer and enforce the various market timing policies and procedures of the different fund complexes with portfolios available through its variable annuities, and that the Commission does not expect insurance companies to do so. The Committee also respectfully requests and recommends that the Commission explicitly state that it would be, or at least could be, reasonable for the board of directors of an underlying variable insurance products fund to determine, after reviewing the market timing policies and procedures of the insurance companies and taking other relevant factors into account, to either (i) adopt as its own the insurance company's market timing policies and procedures *or* (ii) to have no market timing policies and procedures of its own and rely instead on those of the insurance companies.

In addition, the Committee respectfully requests and recommends that the Commission make it clear that if underlying insurance product funds still want to have and enforce their own market timing policies and procedures, then it is the responsibility of the fund to administer and enforce its own policies and procedures. Indeed, a fundamental purpose of the Rule is to enable

[10] Release No. IC-27255, "Mutual Fund Redemption Fees" (February 28, 2006) ("The Commission has not identified any federal rules that duplicate, overlap, or conflict with the proposed rule amendments."), page 52.

[11] These disclosure requirements effectively call for registered separate accounts organized as UITs that fund variable contracts to have policies and procedures to detect and deter frequent transfers, or have a good reason not to have such policies and procedures in place. (For variable annuities, see Item 7(e) of Form N-4; for variable life insurance contracts, see Item 6(f) of Form N-6.)

funds to obtain individual investor transaction data so that the funds can 'look through' intermediaries to enforce the fund's market timing policies and procedures. And, as discussed above, it will be impractical and prohibitively expensive, if not impossible in some cases, for insurance companies to implement and enforce the various market timing policies and procedures of numerous funds in a single variable annuity.

C. Executing Instructions from Funds to Block Trades

The proposed amendments to the Rule also do not address the practical difficulties insurance company issuers of variable annuities face in complying with the Rule's requirement that the intermediary must enter into a written agreement with the fund under which the intermediary agrees to execute fund instructions to impose trading restrictions against investors the fund has identified as violating its market timing policies. For the reasons discussed above, insurers issuing variable annuity contracts have already been required to develop and implement extensive frequent trading detection and deterrence procedures. The Committee strongly believes that, absent some compelling findings by the Commission that insurers' policies and procedures have been inadequate to curb frequent trading by variable annuity contract owners, funds should be permitted to request data downloads and subsequent transaction blocks only as a way to periodically monitor to ensure that the insurer's policies and procedures are effective.

Additionally, we note that Rule 22c-1, the Commission's "forward pricing" rule, requires that the purchase and redemption of a redeemable security be effected at the current net asset value next computed after receipt of a purchase or redemption request. A transfer request from a variable annuity owner may be deemed a redemption of the shares of one fund followed by the purchase (with the proceeds of the redemption) of shares of another fund that is subject to Section 22(c) and Rule 22c-1.[12] If, pursuant to a required written agreement under Rule 22c-2, a fund requests that a variable annuity issuer restrict (or block) a variable annuity owner's purchase and transfer requests, then that issuer faces the predicament of being able to honor the redemption, but not the purchase, aspects of the transfer.

The Committee respectfully requests and recommends that the Commission address this issue by stating that the transfer should be treated as a request "not in good order" so that neither the 'redemption' side nor the 'purchase' side of the transfer should be implemented. A number of practical problems would arise if the 'redemption' side were implemented. Sending the requested transfer amount to the contract owner (outside of the contract) could result in a taxable transaction and tax penalties (for both qualified and non-qualified contracts) and could negatively impact the status of tax qualified contracts. Even if sales loads were waived, there may be premium tax consequences (for both the 'redemption' amount, and if the contract owner sends the money back in with new instructions, because it would be a new premium). More fundamentally, this would not be what the contract owner requested or intended. A transfer was requested; the contract owner did not request a separate redemption and a purchase, so

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[12] *See, e.g.*, Investment Company Institute (pub. avail. Nov. 13, 2002) (stating that, for purposes of the no-action letter, an exchange order is composed of a simultaneous order to redeem shares of one fund and purchase shares of another fund using the proceeds of the redemption).

implementing just the 'redemption' side is completely inconsistent with the investor's intention.[13] Similarly, a 'default' mechanism, where for example the 'redemption' proceeds would be put in something like a money market portfolio, would also be contrary to the contract owner's request (and possibly expose the insurer to liability). Accordingly, the Commission should make it clear that a request to transfer into a 'blocked' portfolio should be treated as 'not in good order' and neither side of the transaction should be implemented.

D. Shareholder Information

In the context of variable annuities (and life insurance), there are numerous 'transactions' that result in a 'purchase' or 'redemption' of units in the separate account. These include death benefits, automatic rebalancing, loans, periodic deduction of charges, etc. And, as the Commission recognized in adopting Rule 22c-2, even outright withdrawals from insurance company separate accounts "are unlikely to occur as part of a market timing or rapid trading policy."[14] This is because of the collateral consequences, such as sales loads, surrender charges, tax consequences, etc. Just as the Rule should be amended to limit redemption fees to transfers in the context of variable annuities, the Commission should make it clear that shareholder transaction information regarding variable annuity contracts can and should be limited to transactions that are susceptible of market timing — that is, only investor initiated transfers between subaccounts.[15] Only information regarding such transfers is relevant to market timing or other abusive trading, and the Committee respectfully requests that the Commission make that clear.

In addition to the type of shareholder transaction data to be provided, underlying insurance product funds should not be permitted to insist on data with such frequency that providing it imposes expensive and unnecessary burdens on insurance companies. Underlying portfolios can certainly protect themselves (and other investors) with regular data downloads no more frequently than quarterly,[16] with the ability to request additional or more frequent data on a "for cause" basis.

In short, the Rule can give underlying funds all the means necessary to detect and deter market timing without giving the funds an unfettered ability to insist on irrelevant data or unnecessarily frequent data. The costs of complying with such requests would ultimately be

[13] Moreover, in the case of variable life insurance policies, this could cause a lapse of the policy, and the loss of the life insurance.

[14] Release No. IC-26782 (March 11, 2005), under the sub-heading "Variable Insurance Contracts."

[15] In this context, automatic programs such as dollar cost averaging and automatic rebalancing are not investor initiated transactions.

[16] We note that in adopting Rule 22c-2, the Commission estimated that funds would request shareholder information quarterly. Release No. IC-26782 (March 11, 2005), p. 41. However, the Rule does not limit in any way the frequency by which funds may request shareholder transaction data, and certain documents being circulated in the industry provide for daily downloads of individual shareholder transaction data.

borne by variable annuity contract owners – many of whom are, after all, investors in registered investment companies.[17]

E. Other Comments

The Committee respectfully submits that the proposed amendments do not address the concerns raised in previous comment letters that raised issues regarding the applicability of the Rule in the context of variable contracts:[18]

- the Rule should provide for uniform redemption fee elements and implementation methods, at least with respect to the applicability of redemption fees to variable contracts;
- the Rule should be amended to limit the assessment of redemption fees solely to transactions initiated by contract owners and to transfers between subaccounts; and
- the Rule should be amended to provide that redemption fees cannot be assessed on other transactions within variable contracts that are not susceptible to being used for market timing purposes.[19]

In addition, the Committee respectfully requests that the Commission address the issue that implementing redemption fees and transaction restrictions and blocks could be viewed as a violation of the terms of existing variable annuity contracts, and perhaps state insurance regulatory requirements, by explicitly and affirmatively stating that it is the Commission's position that:

- abusive short-term trading, or market timing, not only is harmful to other long-term investors, including owners of variable annuities, but also is against public policy;[20]
- the provisions of Rule 22c-2 are intended to apply retroactively to existing variable contracts;

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[17] They would ultimately bear the costs through the charges deducted under the annuity contracts and/or weaker benefits.

[18] *See, e.g.*, Letter from T. Rowe Price Associates, Inc. to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (May 24, 2005); Letter from New York Life Insurance and Annuity Corporation to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (May 12, 2005); Letter from Sutherland Asbill & Brennan (on behalf of the Committee of Annuity Insurers) to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (May 9, 2005); Letter from the National Association for Variable Annuities to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (May 9, 2005); Letter from the Investment Company Institute to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (May 9, 2005).

[19] These issues are addressed in our comment letter of May 9, 2005, which is attached hereto as an Exhibit and incorporated herein by reference.

[20] Of course, this would not be the case for those funds that intentionally accommodate frequent trading activity.

- the provisions of the Rule supercede all conflicting provisions of existing variable contracts; and

- the provisions of the Rule supercede all conflicting state insurance regulations.

These statements by the Commission would be extremely helpful to insurance companies defending themselves against the lawsuits that have arisen and will continue to arise as insurance companies comply with the Rule's requirements regarding blocking trades and imposing redemption fees.

Finally, we note that although many variable annuities are registered with the Commission as securities and issued through separate accounts that are registered investment companies, there also are many variable annuities that are not registered as securities and that are issued through separate accounts that are not registered as investment companies.[21] Unregistered separate accounts, particularly retirement plan accounts, represent a very substantial portion of the variable annuity business.

Unlike most registered variable annuity contracts, unregistered variable annuity contracts may invest in retail mutual funds as well as insurance product funds. In addition, in many cases unregistered variable annuities have the same contractual pricing requirements as registered variable annuities (*e.g.*, a contractual obligation of the insurance company to process transaction requests and provide cash values based on the underlying fund's NAV as of the day of receipt of the order by the insurance company). Insurance companies may also use the same administrative procedures, policies, and computer programs for both their registered and unregistered variable annuities. As a result, the Committee believes that both retail funds and insurance product funds may ultimately apply the same types of redemption fee, information sharing, and transaction blocking procedures to unregistered variable annuity contracts (and the unregistered separate accounts through which they are issued) as they do with respect to registered variable annuity contracts. Accordingly, although unregistered separate accounts may in some cases not be subject to Rule 22c-2, the Committee respectfully requests that the Commission consider the recommendations made in this letter in the context of unregistered as well as registered separate accounts.

* * * * *

The Committee appreciates the opportunity to comment on the proposed amendments to Rule 22c-2, and appreciates the careful consideration by the Commission and its staff of the comments and recommendations set forth herein.

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[21] These unregistered variable annuities are issued as private placements (issued through separate accounts that rely on Investment Company Act Section 3(c)(1) or 3(c)(7) exclusions) or in connection with qualified retirement plan arrangements (not registered in reliance on Investment Company Act Section 3(c)(11)).

Respectfully submitted,

SUTHERLAND ASBILL & BRENNAN LLP

By:

Stephen E. Roth

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W. Thomas Conner

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FOR THE COMMITTEE OF ANNUITY INSURERS

cc: The Honorable Christopher Cox, Chairman
The Honorable Cynthia Glassman, Commissioner
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Annette L. Nazareth, Commissioner

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Committee of Annuity Insurers

SUTHERLAND ASBILL & BRENNAN LLP

2006
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MEMBER LIST

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USAA Life Insurance Company

EXHIBIT A

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May 9, 2005

BY E-MAIL

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Additional Comments to Final Rule Regarding
Mutual Fund Redemption Fees (File No. S7-11-04)

Dear Mr. Katz:

This letter is submitted on behalf of the Committee of Annuity Insurers (the "Committee").[1] The Committee is pleased to have the opportunity to offer its comments in response to the request of the Securities and Exchange Commission (the "Commission") in Release No. IC-26782 (March 11, 2005) (the "Adopting Release") for additional comments on newly-adopted Rule 22c-2 (the "Rule") under the Investment Company Act of 1940, as amended (the "Investment Company Act").[2] The Rule permits open-end management investment companies, including series thereof (referred to as "funds"), to impose redemption fees in order to discourage 'market timing' and/or to recoup expenses incurred due to frequent trading activity.

The Committee supports the Commission's efforts to protect long-term investors in mutual funds ("funds") and variable annuities from abuses stemming from short-term or frequent trading activities. In addition, the Committee is very appreciative that in the Adopting Release, the Commission recognized that significant refinements may be necessary "to address the special circumstances of insurance company separate accounts." These comments are intended to assist the Commission in that important effort. As described below, the Committee believes that as applied to variable annuities, the Rule, as currently worded, may lead to the assessment of redemption fees on transactions within variable annuities that do not pose any risk of abusive trading or have any potential to harm other investors. Furthermore, the Committee also believes that the Rule as currently adopted creates significant administrative complexities and legal issues

[1] The Committee of Annuity Insurers is a coalition of life insurance companies that issue fixed and variable annuities. The Committee was formed in 1981 to participate in the development of federal securities law regulation and federal tax policy affecting annuities. The member companies of the Committee represent approximately half of the annuity business in the United States.

[2] The Rule was initially proposed by the Commission in 2004. See Mandatory Redemption Fees for Redeemable Fund Securities, Release No. IC-26375A (Mar. 5, 2004) [69 FR 11762 (Mar. 11, 2004)] (hereinafter, the "Proposing Release").

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for insurance companies issuing variable annuities.[3] The Committee appreciates this opportunity to provide its comments and recommendations to assist the Commission in refining the operation of the Rule through amendments with respect to variable annuities in areas that reflect the structural realities of variable annuities, yet maintain the spirit and purpose of the Rule.

I. Structure of Variable Annuities

As the Commission is aware, a variable annuity is a written contract between the insurance company that issues the variable annuity and the owner who purchases the contract.[4] Today, in most cases, variable annuities are issued through a two-tiered structure. The top tier consists of a separate account of the issuing insurance company, which is a segregated investment account established under state insurance law that holds variable annuity assets and liabilities separate and apart from the assets and liabilities of the insurance company's general account. Absent an exemption from the Investment Company Act, the separate account is required to register under the Investment Company Act. Generally, separate accounts are registered as unit investment trusts and are divided into subaccounts. The bottom tier of this two-tiered structure typically consists of a number of series mutual funds, and each subaccount corresponds to, and is invested exclusively in, a particular series, or portfolio, of one of the funds. In this manner, today's variable annuities generally offer dozens of subaccount or portfolio choices, and give the contract owner the opportunity to select from portfolios offered by a dozen or more different mutual fund complexes.[5]

For tax reasons,[6] the funds that are available through registered insurance company separate accounts can not be available directly to the public. Accordingly, mutual fund complexes have created separate funds, apart from their 'retail' funds, that are only available to insurance

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3 This comment letter does not address certain aspects of the proposed amendments that would apply to variable life insurance policies as well as variable annuity contracts. However, the issues and concerns, and recommendations, discussed herein apply equally to variable life insurance policies. Moreover, many of these same considerations apply in the context of participant-directed employee benefit or retirement programs. The fact that this comment letter focuses on variable annuities is in no way meant to imply that the matters addressed herein are not equally applicable in such other contexts.

4 For ease of reference, this comment letter refers to insurance companies as issuers of variable annuity contracts although, under the federal securities laws, insurance company separate accounts are the primary issuers of variable annuity contracts, with the insurer as a separate entity co-issuing the contract. *See* Stephen E. Roth, Susan S. Krawczyk, and David S. Goldstein, *Reorganizing Insurance Company Separate Accounts Under Federal Securities Laws*, 46 Business Lawyer 546 (Feb. 1991).

5 One (or more) of those mutual fund complexes may be managed by an affiliate of the insurance company, but most products offer a large number of portfolios that are part of unaffiliated mutual fund complexes.

6 *See* Section 817(h) of the Internal Revenue Code.

company separate accounts (and certain qualified retirement plans); these specially dedicated funds are referred to as "insurance product funds."

Under this structure, variable annuity owners allocate premium payments among the subaccounts offered within the contract, and may transfer contract value among those subaccounts in accordance with the terms of the contract. Each subaccount, in turn, invests in the corresponding portfolio. However, the insurance company is the actual owner of fund shares, and the insurance company does not hold them in trust for the contract owners.[7]

Operationally, variable annuity owners do not actually engage in transactions in shares of the underlying portfolios; rather, contract owner transactions (and other elements of variable insurance products, such as periodic deductions of charges, payment of death benefits, etc.) take place in the form of purchases in or redemptions from the subaccounts. To account for amounts allocated to or withdrawn from a subaccount as a result of purchase payments, withdrawals and transfers, and other items, values in each subaccount generally are measured in terms of "accumulation units." Each subaccount has its own accumulation unit value, which is distinctly different from the net asset value per share of the underlying portfolio. On a daily basis, the insurance company aggregates all orders received from contract owners with respect to a particular subaccount, and transmits net purchase or redemption orders to the fund in which the subaccount is invested.

II. Recommendations of the Committee

In light of the two-tiered structure of variable annuities described above and the inherent differences between mutual funds and variable annuities, the Rule clearly should not apply to investors in variable insurance products in the same manner as it applies to investors in retail mutual funds. Applying the Rule in the same manner to both types of investments is not necessary to achieve the purposes of the Rule, and doing so would cause significant problems for issuers of variable annuities and would be contrary to the best interests of investors in variable annuities. The Commission should have the same interest in acting in the best interests of both direct investors in retail mutual funds and investors in variable annuities, which are also interests in registered investment companies.

Accordingly, the Committee respectfully makes the following suggestions and recommendations concerning the Rule as it would apply in the context of variable insurance products:

- With respect to variable insurance products, the Rule should be amended to limit the assessment of redemption fees solely to transfers between subaccounts, and to

7 *See* Rule 26a-2(a) under the Investment Company Act.

provide that redemption fees cannot be assessed on other transactions within variable annuities that are not susceptible to being used for market timing purposes;

- In general, an amendment should be adopted to limit redemption fees to investor initiated transactions;

- The Rule should provide for uniform redemption fee elements and implementation methods, at least with respect to the applicability of redemption fees to variable insurance products;

- The Commission should more specifically and more broadly address conflicts arising between application of the Rule and the provisions of variable annuity contracts and state insurance law; and

- To reflect the significant administrative complexities and corresponding modifications that insurance companies will need to make to existing systems and procedures, or the development or purchase of new systems, to comply with the Rule, the Committee respectfully requests that the Rule's compliance date with respect to insurance product funds be extended.

A discussion of each of the aforementioned recommendations follows below.

A. Limitation of Redemption Fee to Transfers Between Subaccounts

The Committee recommends that the Commission adopt amendments to the Rule that would (1) limit the assessment of any redemption fee in connection with variable insurance products to transfers between subaccounts (also referred to as exchanges), and (2) prohibit the assessment of redemption fees on those variable insurance product transactions and operations that pose no danger of involving market timing. Currently, operation of the Rule would result in the assessment of redemption fees with respect to any transaction or operation within a variable annuity that resulted in a redemption of shares of a fund that has adopted a redemption fee, regardless of whether the transaction or operation is susceptible to market timing or other abusive trading practices.

As the Commission correctly observed in the Adopting Release, actual withdrawals from variable insurance products are not the types of transactions that are likely to be part of a rapid trading strategy. This is because actual withdrawals (full or partial) may involve consequences that could be significant, including the imposition of surrender charges and possible tax penalties. The Adopting Release states:

> We also envision that the [R]ule would not permit the assessment of redemption fees on the redemption, pursuant to partial or full contract withdrawals, of shares issued by an insurance company separate account organized as a unit investment trust that is registered under the [Investment Company Act]. These types of redemptions are unlikely to occur as part of a market timing or rapid trading strategy, and will permit contract holders to exercise a "free look" provision of their contracts without paying a redemption fee.[8]

We certainly agree that purchasers of variable annuities should not be penalized by underlying fund redemption fees merely because they exercise their *right,* mandated by state insurance law, to be able to return the contract after they have had an opportunity to read and consider it carefully (referred to as a "free look" right). Allowing insurance product funds to impose redemption fees in such circumstances would be inconsistent with those state insurance law requirements. Given the uncertain nature of the Commission's statement quoted above to the effect that it "envisions" that the Rule would not permit redemption fees on withdrawals from variable insurance products, we respectfully request that the Commission clarify this language by stating unequivocally that the Rule (even in its current form) does not permit the imposition of redemption fees on partial or full withdrawals from variable annuity (and life insurance) contracts.

In addition to withdrawals, however, there are numerous other transactions that take place in variable annuities that are clearly not susceptible to a rapid trading strategy, yet the Rule as currently in effect would allow *funds* to impose redemption fees on such innocent transactions. In addition to "free looks" and other withdrawals (including systematic withdrawals), these types of transactions include the following:[9]

- Periodic deduction of charges;
- Automatic rebalancing;
- Dollar cost averaging;
- Payment of death benefits;
- Annuity payouts;

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8 Adopting Release, p. 29.

9 We applaud the Commission for correctly recognizing a number of these in the adopting release, such as contract withdrawals, deductions of periodic charges, systematic withdrawal plans, and periodic rebalancings.

- Full and partial exchanges conducted under Section 1035 of the Internal Revenue Code of 1986, as amended;
- Policy loans; and
- Exercise of guaranteed minimum withdrawal benefits.

For example, an investor might have held a variable annuity for years, not engaging in any transactions (the typical "buy and hold") investor, and then pay an additional premium shortly[10] before the insurance company deducts a periodic charge; under the Rule as it currently exists, a fund could impose a redemption fee on the company's deduction of the periodic charge. Similarly, in many cases a variable annuity is purchased through regular and "automatic" premiums via payroll deduction or automatic drafts against bank accounts, and in such cases there would almost always be a premium payment shortly before a periodic deduction of charges. In addition, investors making regular, periodic investments should not be penalized because they make a one-time withdrawal for a mortgage down payment, or to pay college tuition, or for unusual medical bills, etc.

Moreover, it is important to be cognizant of the fact that the Rule applies, as it should, in situations where there are two separate transactions – a "purchase" into the investment company, followed by a "redemption" out of the investment company. In the context of variable annuities, this means a "purchase" into a particular subaccount, followed by a "redemption" out of that subaccount. As a practical matter, market timing (or other abusive short-term trading) can only be done when both the purchase and redemption are transfers. For example, an annuity contract owner could be making automatic monthly premium payments (*e.g.*, through automatic bank account drafts) and decide to make a transfer. Even if that is the only transfer that the contract owner makes for years, a fund could impose a redemption fee because the transfer takes place within the stated time period of the automatic premium.[11] Therefore, in the context of variable insurance products, the Rule must provide that redemption fees can only be imposed when both the purchase side (beginning the holding period) and the redemption side are owner initiated transfers. Otherwise, there could be many instances where innocent, long-term and non-timing investors in variable insurance products would be unfairly penalized by redemption fees.

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[10] Actually, it would not have to be "shortly" before a periodic deduction for charges, because there is no limit on the length of time during which a fund could impose a redemption fee.

[11] If, for example, the holding period was 30 days, then a contract owner making regular monthly premium payments could never make a transfer without being penalized by a redemption fee, unless the Rule provides that a redemption fee can not be imposed unless both the purchase (beginning the holding period) and the redemption are investor initiated transfers.

The aforementioned transactions and operations do not involve, and are not susceptible to being used for, market timing or other abusive short-term trading purposes. These transactions and operations typically involve one-time events or are scheduled to occur on an automatic and systematic basis outside the discretion of the owner. In addition, they may be subject to annuity contract fees, expenses, tax penalties, and other consequences.

It might be difficult to clearly define all of the various transactions and operations in variable insurance products that are not susceptible to or appropriate for market timing or other rapid trading strategies, and that do not have the effect of diluting the interest of other investors. Fortunately, there is no need to do so, since transfers between subaccounts are really the only transactions in variable insurance products that can be abused by certain investors to the detriment of others.

Therefore, for the reasons stated above, the Committee strongly urges the Commission to amend the Rule to require – as a mandatory limitation - that with respect to variable insurance products, redemption fees can only be imposed on transfers between subaccounts and cannot be imposed in connection with other transactions and operations such as those identified above.[12] Allowing funds to impose redemption fees on those other transactions and operations, regardless of whether the transaction has anything to do with, or is even susceptible of being used with, market timing or rapid trading strategies is clearly contrary to the best interests, and protections, of innocent investors.

B. <u>Limit to Investor Initiated Transactions</u>

The Commission stated in the Adopting Release that it is considering whether the Rule should require that any redemption fee assessed by a fund be limited to circumstances in which the transaction giving rise to the assessment was initiated by the investor. For example, the Commission indicated that it received comments supporting an exemption for transactions executed pursuant to prearranged instructions, such as periodic contributions, periodic rebalancings, or other "involuntary transactions," and the Commission specifically noted that such transactions "appear to pose little or no short-term trading risk."[13] Although the Adopting

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[12] This would be consistent with the current "market timing" disclosure requirements applicable to variable annuities. Those requirements are, among other things, to disclose whether the separate account or the insurance company has policies and procedures "with respect to frequent ***transfers*** of contract value among sub-accounts" (Form N-4, Item 7(e)(ii), emphasis added). There is no requirement, nor should there be, to disclose any such policies and procedures with respect to any other transactions or operations.

[13] <u>See</u> Adopting Release at n. 74. The Commission should make it clear, as the Adopting Release indicates, that "automatic" transactions, such as periodic rebalancing, automatic premium payments (via payroll deduction or bank account drafts), systematic withdrawals (including, for example, withdrawals pursuant to guaranteed minimum withdrawal benefit options), annuity payouts, etc. are not 'investor-initiated.' Although the investor did, of course,

Release's discussion regarding an investor-initiated transaction limitation focused for the most part on transactions within retirement plans, such transactions and operations are similar to the variable annuity transactions and operations noted above that are automatic and do not pose any risk of market timing or other short-term trading abuse.

Accordingly, the Committee recommends that the Commission adopt amendments to the Rule that would limit the assessment of redemption fees solely to circumstances in which the specific transactions giving rise to the assessment (both the purchase side and subsequent withdrawal) were initiated by the investor,[14] and to provide – as a mandatory limitation – that redemption fees cannot be imposed on reinvested dividends or other distributions, or on shares purchased or redeemed pursuant to a prearranged contract, prearranged or standing instructions, or similar plans.[15]

In the context of variable annuities, transactions that are not investor initiated are easily identifiable, since they occur without a specific 'trade order' from the contract owner for the particular transaction.

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initiate the automatic or systematic plan or program, the investor does not initiate each individual withdrawal transaction.

[14] The Committee would point out that an owner of a variable insurance product can acquire accumulation units in a subaccount in several ways. Obviously an owner can acquire accumulation units through a direct allocation of premium payments to the subaccount. In addition, an owner can acquire accumulation units by transferring contract value allocated to a different subaccount to such subaccount. Each of these transactions may be conducted via investor initiated transactions or by one of the automatic transactions described above. However, the Committee recommends that the Commission adopt amendments to the Rule that would limit the assessment of redemption fees solely to instances in which a contract owner acquired accumulation units through an investor initiated transaction, and subsequently redeemed the accumulation units through an investor initiated transaction. Such an amendment would maintain the spirit of the Rule while preventing it from being applied in circumstances that do not pose any risk of market timing or other short-term trading abuse.

[15] This would include portfolio rebalancing, systematic periodic withdrawals, etc., and provide the same type of protections to non-market timing investors in retail mutual funds as are recommended above in the context of variable annuity contract owners. This limitation should also apply to redemptions arising from transactions completely outside the control of contract owners, such as redemptions of shares of a fund underlying a variable insurance product due to a substitution or merger of such fund. Furthermore, at least with respect to variable insurance products, the Committee respectfully requests that the Commission make it clear that in the context of a fund of funds, a redemption fee can only be imposed on investor initiated transactions (*i.e.*, contract owner transactions), and that a bottom-level fund cannot impose redemption fees on transactions by the fund of funds. It is not clear whether the Rule as currently in effect achieves this result. Although the definition of "shareholder" in subsection (c)(4) does exclude a fund investing pursuant to section 12(d)(1)(G) of the Investment Company Act, we note that the term "shareholder" does not appear in subsection (a)(1) of the Rule (it is only used in subsection (a)(2)). Subsection (a)(1) is the 'redemption fee' provision, while subsection (a)(2) is the 'shareholder information' provision.

C. Uniformity of Fee Elements

1. Need for Uniformity

Under the Rule, a unit investment trust separate account[16] is deemed to be a "financial intermediary," and is thereby required to enter into a written agreement with the fund (or its principal underwriter) whereby the separate account agrees to (1) provide promptly upon request the Taxpayer Identification Number and specific transaction data for all variable annuity contract owners, and (2) execute any instructions from the fund to restrict or prohibit further purchases or exchanges of fund shares by any owner who has been identified as having violated the fund's trading policy.[17]

As noted above, today a typical variable annuity contract offers a large (and growing) number of portfolio choices from a substantial number of different mutual fund complexes. Allowing different redemption fees with different elements in the same variable annuity would lead to significant disclosure problems for insurers, and, more importantly, is very likely to be bewilderingly confusing to purchasers of variable annuities. Without uniform standards, an investor in a given variable annuity product could be faced with a dizzying array of 8, 10, or 12 different redemption fees (imposed by different mutual fund groups) that could vary in amount, holding period, accounting methods, applicability, etc. Even a sophisticated, intelligent investor, who is not market timing, could easily get surprised with an unexpected redemption fee.

In addition, unless uniform standards and elements for redemption fees are adopted, insurance companies may be required to implement dozens of different redemption fees in a single variable annuity product, with different percentage amounts, holding periods, accounting methods, and exceptions and limitations. This would exponentially multiply the difficulties and expenses that insurers will face even in implementing a single redemption fee. As recognized by the Commission, insurance companies will have to make significant and costly changes to their existing administrative systems and procedures. Systems and procedures would need to be modified to monitor, identify and track transactions in subaccounts that would lead to the assessment of redemption fees. Without uniform standards, such systems and modifications would be required to account for any differences in the redemption fee policies of the various underlying funds in which the contract is invested.

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16 As we understand it, this includes both registered and unregistered separate accounts, such as accounts relying on the exemptions in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

17 As noted above, variable annuity contract owners do not purchase or exchange fund shares - they are not fund shareholders. Rather, their transactions take place at the separate account level in the form of accumulation units.

Lack of uniformity is likely to lead insurance companies to eliminate a number of investment choices from variable insurance products, which is hardly in the best interests of investors in those products.

In light of these issues, the Committee recommends that the Rule be amended to adopt uniform standards, at least with respect to the applicability of redemption fees to variable insurance products. Specifically, the Committee recommends that the Commission amend the rule to provide for uniform standards with respect to the amount of the redemption fee and the holding period in the context of variable insurance products.[18] In addition, and as discussed in more detail below, the Committee recommends that the Commission amend the Rule to provide for uniform standards with respect to the fee assessment method, share accounting method, and de minimis exception.

Uniform standards would serve to reduce the considerable administrative complexities facing insurance companies issuing variable annuities under the Rule, as well as reduce the significant costs insurance companies will incur in modifying their administrative systems and procedures to ensure compliance with the Rule. More importantly, uniformity would ease disclosure issues and help limit, if not eliminate, investor confusion. In this regard, the Committee believes that uniformity itself is critical, and much more important than the specific elements of that uniformity.

2. Fee Assessment Method.

As discussed in the Proposing Release and Adopting Release, the Commission has proposed allowing funds and financial intermediaries to utilize three methods of assuring that appropriate redemption fees are imposed.

Under the first method, the intermediary would transmit to the fund (or its transfer agent), upon submission of each purchase and redemption order, the account numbers used by the intermediary to identify the investors. This method would require an insurance company to transmit to the fund on a daily basis with respect to each contract owner the account number and the dollar amount of the owner's purchase or redemption (or transfer) transaction. This information would enable the fund to match the current transaction with previous transactions by the same account and assess the redemption fee when it is applicable.[19]

[18] In the context of applying the Rule to variable insurance products, the Committee recommends that the amount of a redemption fee be set at a uniform 2%. With respect to the holding period, the Committee cautions that a period that is longer than necessary to combat market timing (and other abusive short-term trading) undermines the fundamental concept of redeemability.

[19] Consistent with the discussion in Section A above, if this method is utilized (either by choice or because it is mandated by the Rule), then for variable insurance products, information need only be supplied with respect to

Under the second method, the intermediary would transmit to the fund, as to redemption orders upon which the redemption fee would apply, transaction and holding information sufficient to permit the fund to assess the amount of the redemption fee. In effect, an insurance company would identify redemptions that trigger the application of the redemption fee and provide related information to the fund. This second method would require substantially less data transmission to the fund than the first method.

Under the third method, the financial intermediary, pursuant to an agreement with the fund, would be obligated to deduct the redemption fee as an administrative service on behalf of the fund and remit the proceeds to the fund.[20] This method would alleviate the burden on an insurance company of transmitting contract owner account and transactional information to the funds on a transaction-by-transaction basis. Although under this method an insurance company would administer the fee on behalf of the fund, it would still be entirely up to the fund (specifically, its board of directors) to decide whether to adopt a redemption fee, and what the elements of that fee would be (amount, holding period, exceptions, etc.) to the extent not mandated by rule.[21]

The Committee believes that the Commission should mandate a single method. The Committee also believes that it should be the third method. There does not appear to be a viable method for underlying funds to deduct the fee from an individual contract owner's account, which is where the deduction must take place. As a practical matter, only the issuing insurance company can deduct the fee from a specified contract; the fund can only deduct the fee from the insurer's omnibus account, which could result in the fee being spread among and borne by all investors in the applicable subaccount. Accordingly, the Committee believes that the Commission should mandate the third method.

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investor initiated transactions that begin a holding period and transfers between subaccounts. Similarly, consistent with Section B above, under this method information would only need to be supplied with respect to investor initiated transactions. Amendments to the Rule or the attendant Commission release should make this clear.

20 Many insurance companies currently have administrative service agreements with underlying funds, whereby the insurance company provides certain "shareholder" level services to contract owners on behalf of the fund.

21 Even under this method, the insurance company does not have the power to decide whether or not a redemption fee should be imposed. However, in describing the third method, the Adopting Release uses language that mischaracterizes the intermediary's role. The Adopting Release states that the agreement with the fund would require the intermediary "to impose the redemption fee." (Adopting Release, text at n. 86). This language is absolutely inconsistent with the Commission's position that the application of Rule 22c-2 does not present conflicts with the terms of outstanding annuity contracts or state insurance law. In footnote 62 to the Adopting Release, the Commission states: "The redemption fee would be imposed by the *fund* rather than pursuant to a contract issued by the insurance company." (Emphasis in original, citing *Miller v. Nationwide Life Ins. Co.*, 391 F.3d 698 (5th Cir. 2004). It is imperative that the Commission clarify that even under the third assessment method, it is the fund, and not the insurance company, that imposes the redemption fee.

In the alternative, if the Commission ultimately decides to permit all three fee assessment methods, the Committee believes that in the context of variable insurance products, the insurance company should be the entity that determines which method is utilized. Permitting insurance products funds to specify the method used will result in insurance companies facing considerable complexities if the funds underlying the variable annuities select different methods. On the other hand, allowing the insurance companies to determine the method utilized would promote greater uniformity in the enforcement of redemption fees under the Rule.

3. Share Accounting Method.

The Committee also recommends that the Rule be amended to require that funds utilize a uniform share accounting method in determining the assessment of redemption fees. Adopting a uniform share accounting method would considerably reduce any administrative complexities, thereby promoting greater uniformity in the enforcement of redemption fees under the Rule, as well as reduce the related costs.[22]

4. De Minimis Waiver.

The Committee recommends that the Commission amend the Rule to provide for a de minimis waiver of the redemption fee with respect to smaller transactions. As the Commission noted in the Adopting Release, a de minimis waiver would help serve to prevent the assessment of redemption fees where they are not appropriate.

The Committee also recommends that the Rule be amended to provide that the de minimis waiver be made uniform and mandatory in the context of all funds, or in the alternative, at least with respect to variable insurance products. Making the de minimis waiver uniform and mandatory would simplify disclosure issues and reduce investor confusion regarding the waiver's applicability with respect to variable insurance products. Such an amendment would also serve to reduce the administrative complexities faced, and costs to modify administrative systems and procedures incurred, by insurance companies under the Rule.

In addition, the Committee recommends that the Rule be amended to provide for a de minimis waiver provision that is tied to a uniform redemption amount, rather than the amount of the redemption fee. A de minimis waiver tied to a uniform transaction amount would reduce the costs associated with insurance companies and other intermediaries being forced to accommodate funds assessing various levels of redemption fees (especially if the Rule is not amended to

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[22] Determining the amount of any redemption fee by using the "first in, first out" ("FIFO") method of accounting has the advantage of helping to avoid the inadvertent (and unnecessary and harmful) imposition of a redemption fee on purely innocent transactions that have nothing to do with market timing ((*e.g*, periodic deductions of charges, automatic rebalancings, etc.).

provide for a uniform fee). In this regard, the Committee recommends that the transaction limit be set at $10,000. Such a limit would prevent the application of the Rule to smaller investors who redeem their fund shares shortly after purchase due to unanticipated personal financial circumstances, while still protecting funds and other investors from market timing and other trading abuses.

D. <u>Contract Provisions and State Insurance Laws</u>

Application of the Rule in the context of variable annuities also raises significant legal issues with respect to (a) the contractual terms of variable annuity policies, and (b) state insurance law.[23]

Owners of variable annuities enter into legally binding contracts with issuing insurance companies, and these contracts specify the rights and responsibilities of each of the parties, including maximum or guaranteed charges as well as contract owner ***rights*** to make transfers among subaccounts. Neither party to a legally binding contract can change that contract without the consent and agreement of the other party. If an insurance company executes instructions from the fund that restrict or prohibit further purchases or exchanges *among subaccounts* by a contract owner, as the Rule in effect requires, experience shows that contract owners will sue insurance companies for breach of contract.[24] Specifically, many contracts provide that owners have the right to make unlimited transfers, and often such contracts permit such transfers to be made without charge, or with a specific limit on any charge (a common provision is a limit of $25, and a restriction that even that fee can only be imposed after a certain number of free transfers in any year). As a result, insurance companies issuing variable annuities will be subject to substantial litigation risk by restricting transfers in existing contracts, in accordance with the Rule, despite the terms of the contract.

Similarly, variable annuity contracts specify, as terms of the contract, what fees and charges can be imposed by the insurance company. Again, contract owners have sued for imposing

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23 Retail fund shareholders do not have *contracts* with the fund, and state insurance law policy form approval and other requirements do not apply to retail funds.

24 Numerous lawsuits alleging breach of contract have been filed by market timers *See, e.g , Prusky v. Reliastar,*2005 WL 226148 (E.D. Pa. 2005); *Prusky Aetna Life Ins. And Annuity Co.*, 2004 U.S. Dist. LEXIS 21597 (E.D. Pa. 2004); *American National Bank and Trust Co. of Chicago v. Allmerica Financial Life Ins. And Annuity Co.*, 2003 U.S. Dist. LEXIS 6706 (N.D. Ill. 2003); *Prusky v. Phoenix Life Ins. Co.*, 2003 U.S. Dist. LEXIS 4054 (2003); *First Lincoln Holdings v. Equitable Life Assurance Society of the United States,* 43 Fed. Appx. 462, 2002 U.S. App. LEXIS 18004 (2nd Cir. 2002); *American National Bank and Trust Co. of Chicago v. AXA Client Solutions, LLC,* 2001 WL 743399 (N.D. Ill. 2001); *Windsor Securities Inc. v. Hartford Life Ins. Co.* 986 F. 2nd 655 (3rd Cir. 1993). In addition, in a number of instances actual or threatened lawsuits have been settled without litigation, but at not insubstantial costs to insurance companies. There is no reason to believe that the Rule will preclude such lawsuits and claims in the future.

redemption fees,[25] and are likely to sue in the future if redemption fees are imposed where the annuity contract does not expressly provide for them. We expect such lawsuits to be against the insurance company, rather than against the underlying fund that imposes the redemption fee.[26]

We are, of course, aware that in footnote 62 to the Adopting Release, the Commission stated that:

> Nor do we believe, as several commentators suggested, that the application of [the Rule] will present an insuperable conflict with state insurance laws when a redemption fee is imposed on transactions by holders of existing variable annuity or variable life insurance contracts. The redemption fee would be imposed by the *fund* rather than pursuant to a contract issued by the insurance company.[27]

However, we respectfully point out that in making that statement, the Commission relied on a single court decision. Moreover, the Court of Appeals did not address the redemption fee issue; it affirmed the district court on other grounds. We respectfully submit that a single decision by one district court is hardly a sound basis for subjecting insurance companies to such significant litigation risks across the nation. Therefore, we respectfully request and recommend that the Commission do whatever it can to help alleviate the very serious problems, described above, that the Rule creates for issuers of variable annuities

Accordingly, in light of the very serious litigation risks that the Rule creates for issuers of variable insurance products, the Committee respectfully requests and recommends that the Commission clearly and affirmative state that, in its view, public policy in general, and specifically the policies and purposes of the federal securities laws, clearly support, if not compel, interpreting variable annuity contracts <u>and</u> state insurance laws (a) as permitting redemption fees in accordance with the Rule, and (b) as permitting restrictions and prohibitions on transfers by variable annuity contract owners. Such interpretations are, we submit, necessary for the protection of long-term investors in variable annuities.

The Committee agrees with the Commission that redemption fees assessed pursuant to the Rule should be deemed to be assessed by the underlying fund rather than the insurance company. On similar policy reasons, the Committee believes that if an insurance company restricts transfers within a contact owned by an owner identified by the fund as violating the fund's trading policies pursuant to instructions received by an underlying fund, such restrictions should be deemed as

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25 *See Miller v. Nationwide Life Ins. Co.*, 391 F.3d 698 (5th Cir. 2004).

26 As noted above, owners of variable annuity contracts are ***not*** shareholders of the underlying funds, and do not have privity of contract with the funds. Accordingly, variable annuity contract owners may not have any ability to sue the underlying funds.

27 Citing *Miller v. Nationwide Life Ins. Co.*, 391 F.3d 698 (5th Cir. 2004).

imposed by the fund and not by the insurance company.[28] In this regard, the Committee respectfully requests that the Commission explicitly set forth its position that under the Rule, any redemption fees and transfer or purchase restrictions would be imposed by the underlying fund, and any such fees or trading restrictions are merely administered by the insurance company on behalf of the fund. We believe that this should be made clear in amendments to the Rule itself as well as in any release by the Commission adopting amendments to the Rule.

Finally, we respectfully request that the Commission explicitly state its intention (indicated by footnote 62 of the Adopting Release) that the Rule, and interpretations thereof, should apply in the context of existing variable annuity contracts (*i.e.*, "in force" contracts).

E. <u>Extension of Compliance Date For Insurance Products Funds</u>

As discussed above, under the Rule, insurance companies will be required to enter into written agreements with funds (or their principal underwriters) to provide variable annuity owner and transaction data as well as execute any instructions from the fund to restrict or prohibit further purchases or exchanges of fund shares by any owner who has been identified as having violated the fund's trading policy. Many insurance companies will be required to enter into dozens of such written agreements, as well as renegotiate and amend participation agreements and other contracts with underlying funds. Furthermore, as described above and noted by the Commission, insurance companies will be required to make significant and costly changes to their existing administrative systems and procedures, and/or develop or purchase new systems.

Finally, as noted above, insurance companies will in many cases be required to prepare new policy forms and file the new forms (and contract amendments) with state insurance departments to reflect the ability to deduct redemption fees and restrict or prohibit transfers. In many states, new policy forms and amendments cannot be used until a considerable, and indefinite, period of time following filing (*e.g.*, until the state insurance department gives its approval) that is beyond the control of the insurance company.

To account for the considerable time it would take insurance companies to address these issues, the Committee respectfully requests that the compliance date for the Rule with respect to insurance products funds be extended to at least two years after adoption of amendments to the Rule. This extension would give issuers of variable annuities the necessary additional time to enter into written agreements with fund complexes, make required modifications to existing

[28] See footnote 21 above.

administrative systems and procedures and make any necessary filings with state insurance departments to ensure that they are in compliance with the Rule.[29]

F. Board of Director's Considerations

Finally, the Rule requires the Boards of Directors of all mutual funds, including insurance products funds, to make an affirmative decision as to whether to impose redemption fees. In the context of insurance products funds, we also note that the registration statement forms for variable insurance products require that the product's prospectus disclose whether the insurer has policies and procedures with respect to frequent transfers among subaccounts (*i.e.*, market timing policies and procedures). The Committee believes that it would be entirely appropriate for the Board of Directors of an insurance products fund to determine that it is not necessary or not appropriate for that fund to impose a redemption fee on the basis that the participating insurance companies have themselves adopted appropriate policies and procedures to protect investors from frequent trading.[30] We respectfully request that the Commission include a statement to that effect in a release adopting amendments to the Rule.

* * *

The Committee appreciates the time and resources that the Commission and its staff have devoted to rulemaking initiatives aimed at protecting investors from market timing and other trading abuses. The Committee also appreciates your careful consideration of our comments and recommendations set forth herein.

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29 We note, with appreciation, that the Adopting Release does indicate that the compliance date may be extended if the Rule is amended in response to comments. *See* Adopting Release, n. 91.

30 Of course, such a determination would depend on an appropriate review and evaluation of the insurance companies' policies and procedures, and could be reversed or changed by the fund's board at any time.

Respectfully submitted,

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